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C O N F I D E N T I A L SECTION 01 OF 07 BRASILIA 003100

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NSC FOR FARYAR SHIRZAD/TOM SHANNON
STATE PASS USTR
DEPT OF TREASURY FOR FPARODI

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TAGS: ECON EFIN ETRD ECIN EINV BR BL AR
SUBJECT: DEPUTY NATIONAL SECURITY ADVSIOR SHIRZAD'S NOV, 22-23 MEETINGS WITH BRAZILIAN ECONOMIC POLICYMAKERS AND PRIVATE SECTOR CONTACTS

REF: BRASILIA 2447

Classified By: ECONOMIC COUNSELOR BRUCE WILLIAMSON, REASON 1.4(B).

¶1. (C) SUMMARY AND INTRODUCTION. At a November 22 dinner for visiting Deputy National Security Advisor Faryar Shirzad and NSC Director Del Renigar, senior executives of key Brazilian and multinational companies questioned Brazil's continued membership in Mercosur (in its current configuration as a customs union), noting that Argentina, in particular, is preventing Mercosur from entering into meaningful trade agreements. The next day Shirzad and Renigar traveled to Brazilia for a series of meetings with senior GOB economic policymakers. Among the delegation's interlocutors were Finance Minister Antonio Palocci, Central Bank Governor Henrique Meirelles, Presidential Foreign Policy Advisor Marco Aurelio Garcia, and Foreign Ministry Under Secretaries Clodoaldo Huguеney (WTO and Bilateral Trade) and

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Luiz Filipe de Macedo Soares (South America and FTAA). The wide-ranging discussions with the GOB touched upon a variety of issues, including prospects for the Doha Round, views of Brazilian business towards trade talks, regional economic integration, the future of Mercosur, the state of play on FTAA, and macro-economic, monetary, and tax policy. The highlights: U/S Hugueney had specific thoughts about how to best proceed on the Doha Round; Presidential Advisor Garcia disclosed that the GOB did not plan to renew its IMF Standby program upon when it expired in March 2005; Finance Minister Palocci expressed concern about the need for an adjustment in the USG's current account; and Central Bank Governor Meirelles made it very clear that he and FinMin Palocci were the ones dictating GOB orthodox macro-economic policies (and that these policies would continue). END SUMMARY AND INTRODUCTION.

WTO Doha Agenda

¶2. (C) Ambassador Clodoaldo Hugueney, Under Secretary for Economics and Technological Affairs, provided a comprehensive review of GoB interests and expectations for progress in the WTO Doha Development Agenda trade talks. Hugueney was explicit that the Doha Round is the GoB,s top trade priority. He said the GoB prefers multilateral negotiations because they will provide greater commercial gains than bilateral or regional accords due to Brazil,s diversified trade structure (in terms of products and export markets). Hugueney noted that a recent World Bank study had reached a similar conclusion, and registered concern that the growing number of bilateral and regional negotiations could divert attention from the Doha Round. Hugueney pointed out that certain issues, such as agricultural subsidies, which are central to agricultural liberalization -- a key GoB interest, can only be solved at the WTO level. As a further benefit of the multilateral talks, he noted the more abundant opportunities for various trade-offs, which can help to facilitate negotiations from the domestic side. (Note. Hugueney added that he believed fewer trade-off possibilities was largely to blame for the failure to conclude FTAA and Mercosur-EU negotiations.)

Doha Timing

¶3. (C) According to GoB thinking, the Doha Round needs to be completed by the end of 2006 -- before the mid-2007 expiration of an extended Trade Promotion Authority (TPA). Should the negotiations drag into 2007, Hugueney contemplated two scenarios, both undesirable from a GoB perspective. In one scenario, negotiators facing a mid-2007 cut-off would adopt a quick-fix, reducing the scope of the agreement. Alternatively, he foresaw the possibility of protracted negotiations, extending way beyond 2007 due to a hiatus awaiting passage of new TPA legislation. Hugueney downplayed any possible affect from Brazilian presidential elections in 2006 on a Doha timeframe, claiming a broad domestic consensus exists in favor of the negotiations and Itamaraty,s handling

of them.
¶4. (C) Hugueney argued that the following elements need to be in place by the December 2005 Hong Kong Ministerial to make possible a 2006 end-date: agreement must be reached on modalities for agriculture negotiations; there must be a refinement of the scope for industrial products; revised offers for services must be made; as well as progress on development issues, including cotton, implementation, and special and differential treatment. While noting that "accidents," such as TPA initial expiration, changeover of EU Commissioners, and CAP reform, could complicate the discussions, he believed these objectives are feasible by the Hong Kong meeting. While not mentioning Brazil,s own candidate for the WTO DG job, Hugueney said he hoped the selection process would be less contentious than last time lest it slow down the negotiations. Certain institutional issues, such as inadequate secretariat funding and ineffective organization for support of the negotiations, also need to be addressed, but he believed could be handled in discussions parallel to the substantive negotiations.

Progress by Hong Kong

¶5. (C) The agriculture modality talks will hinge on market access, according to Hugueney, who described market access barriers as the last line of defense for many developing countries, which do not have the resources to utilize export and domestic support. He argued against a legalistic approach toward defining criteria for graduation of developing countries, which he claimed would mire the negotiations. Instead Hugueney pressed for a more common sense approach saying its obvious that the same rules cannot apply to vastly different types of countries, such as Switzerland and India. When asked by D/NSA Shirzad to elaborate, Hugueney cited the extent of a country,s rural poverty and subsistence farming as examples of factors that should be considered. However, he claimed Brazil would be willing to take on different market access commitments from other developing countries because of its overall competitiveness in agriculture, despite the fact that it also still has severe problems with rural poverty.

¶6. (C) Hugueney said Brazil will continue to play a key role in keeping the G-20 constructively engaged in the process, but cautioned that a refusal by others to make accommodations in market access rules for members which are more defensive on agriculture would likely push them more in line with the protectionist G-10, making an agreement much more difficult to reach. Although diverse tariff structures and differences in offensive and defensive interests present challenges for the G-20, Hugueney said the group will continue to formulate proposals. He added that the G-20 is committed to achieving agriculture modalities by Hong Kong. (The next G-20 Ministerial is slated for February in New Delhi.)

How to Move Forward

¶7. (C) Hugueney opined that the Five Interested Parties (FIP) group worked well when convened at minister level, but was frustrating at the high-official level. He said the GoB recognizes that some type of small group process is essential for making deals, but did not think it useful to reconvene the FIPs until perhaps March or April next year. In the intervening months, Hugueney suggested ramped-up consultations, perhaps even a mini-ministerial, to assuage the concern of some countries over exclusion from the FIP process and to better identify issues. An FIP meeting in March/April could then kick off a more intensive phase of negotiations to produce results before the last sessions of the Agriculture Committee and General Council in July. At that point, it should be possible to articulate what would be the preferred/possible outcome in Hong Kong -- if not full modalities for agriculture, perhaps a partial package. In the run up to Hong Kong, attention would have to be paid to both specific issues and to the emerging package as a whole.

Receptiveness of Brazilian Industry to Trade Talks
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¶8. (C) D/NSA Shirzad queried Hugueney regarding the attitudes of Brazilian industry towards multilateral trade talks and whether the GOB periodically consulted with the country's private sector. Hugueney replied he regularly conducted such consultations, and that one could detect three general clusters of industry views. First, there was a bloc of modern firms, whose managers strongly favored trade liberalization as their competes were well positioned to take advantage of increased opportunities in foreign markets. A second cluster of companies, still most dependent on domestic sales, was less enthusiastic about trade talks, though with support and a new generation of investment would be able to compete should highly-efficient foreign firms enter the

market. Problems arose, however, with regard to the third cluster of firms, which if further market opening took place would not be competitive no matter how much time they had to prepare. Fortunately, he said, this third cluster -- which vehemently opposed the FTAA -- has not been vocal in opposition to the WTO Doha Round.

FTAA

¶9. (C) Ambassador Luiz Filipe de Macedo Soares, Under Secretary for South America, provided a less detailed and

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less enthusiastic discourse on FTAA negotiations to Shirzad, Renigar and emboffs. First, Macedo Soares emphasized the importance of South America in President Lula,s foreign policy, noting institutional changes within the Foreign Ministry that reflect its commitment to follow through on this long-standing Brazilian interest. On the negotiations themselves, he recapped the main FTAA events leading up to last year,s Miami Ministerial, as well as the subsequent Trade Negotiating Committee meeting in February of this year and smaller group discussions, which failed to reach agreement on implementation of the Miami compromise. Macedo Soares insisted that Mercosul,s proposal last year to change the FTAA reflected an interest in finding a way forward for the negotiations given the paralysis that existed within the negotiating groups, a paralysis resulting not from Brazilian interests, but from differing positions between all the FTAA countries.

¶10. (C) Although the FTAA negotiations are currently "dormant," Macedo Soares opined that all parties want to go on with the negotiations once establishment of the framework is complete. On timing, he said he "supposed" the negotiations will be complete next year, after first saying the GoB was "open to," he then changed to "would like to" host a ministerial in the first semester of next year. When asked by D/NSA Shirzad about implications should the FTAA remain stalled, Macedo Soares noted that the U.S. has active bilateral negotiations within the region and that it is in the interests of all that there be an agreement covering Mercosul as well. He claimed there should be no doubt Mercosur favors free-trade and said characterization of Mercosul as "systemically less ambitious" is unfair, even if there are instances when economic interests and asymmetries warrant less ambition.

Mercosur-EU

¶11. (C) According to Macedo Soares, the GoB has lost no enthusiasm for reaching a trade deal with the EU, and has interpreted agreement by the new EU Commission to hold a meeting shortly after its investiture as signaling a similar level of commitment from that bloc. (Note: The December 2 meeting in Rio is reportedly only to allow technical staff to set up a work plan; a Ministerial is planned for next March. End note.) Macedo Soares confirmed GoB aspirations for Mercosur to transform into a EU-type common market. He noted Brazilian interests in strengthening the political dimension of the bloc, including development of a Mercosur Parliament, and the on-going work to update the 1994 Ouro Preto protocol to reflect institutional changes over the last ten years. He downplayed the bloc,s internal difficulties assuring us that the EU has had its share of problems without facing collapse, and rejected recent calls from some quarters for Brazil to negotiate trade agreements independent from its Mercosur partners, claiming it is precisely negotiation as a bloc that prompted EU interest in a trade deal. (Note. Roberto Gianetti da Fonseca, new head of the Sao Paulo Federation of Industries, Foreign Trade Department, recently proposed that Mercosul devolve into a free-trade area allowing its members to negotiate separate trade agreements.)

State of Play in South America

¶12. (C) "Very bad" was Macedo Soares, stark assessment of the state of affairs in South America. This is one reason, he noted, for the current push toward regional integration -- to establish a "system" of countries that can act as a support structure and to foster greater cooperation. (Note. Unclear if he was referring to the South American Community of Nations initiative to be signed in Cuzco, Peru on December ¶9. End note.) He pointed out the substantial physical barriers to movement between the countries of South America and identified transportation infrastructure projects as a priority for the region. He also noted that politically, countries of the region are becoming much more open to cooperation, placing aside issues of sovereignty in accepting assistance from neighboring countries. A case in point was the solicitation by a number of countries (Costa Rica, Nicaragua, Ecuador) for Brazilian support during the recent Rio Group meeting. The GoB is also trying to strengthen

President Mesa of Bolivia by providing deliverables, such as forgiveness of the Bolivian debt, but Macedo Soares described his situation as precarious.

Central Bank Governor Meirelles and FinMin Palocci
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¶13. (SBU) D/NSA Shirzad also met (separately) with Central Bank Governor Henrique Meirelles and Finance Minister Antonio Palocci. Meirelles stated that Brazil is living its best economic moment in his lifetime. GDP growth rates over the last three quarters had exceeded six percent, he said, and the economy was continuing to grow strongly, albeit at a decreasing rate. While in the past Brazil had experienced brief episodes of growth (average growth over the last decade, for example, was only 1.8%), the current expansion, he argued, was on a much more sustainable footing than past recoveries, primarily because of the strongly positive external accounts. The trade surplus, he declared, driven by booming and well-diversified exports, had led to a strong current account surplus. Debt levels were falling, as were risk indicators such as exports as a percentage of GDP. The trade surplus was feeding the foreign exchange market at the rate of $150 million/day, he observed, and the dollar was weakening against the real. The recovery was also capital goods and consumer-durables led, which suggested increasing investment.

¶14. (SBU) According to Meirelles, despite the current elevated growth numbers, potential GDP growth was only about 3.0 to 3.5%. When inflation began to re-emerge, he continued, the Central Bank tightened monetary policy to try to bring growth towards that level. Meirelles felt that an inflationary bias in the economy still remained from the period of hyperinflation, when industrialists played the game of adjusting their prices faster than wages could adjust. He called such price increases short-sighted, as the erosion in workers' purchasing power had contributed to subsequent recessions. It would take continued growth in investment levels to expand the economy's potential growth capacity, he concluded.

¶15. (SBU) Meirelles felt that the GOB's microeconomic agenda (i.e, bankruptcy reform, judicial reform, creation of a mortgage market) would begin to improve the business environment. Central Bank independence would help, he added, although he was uncertain the proposed legislation to implement this would be approved next year. Moreover, he suggested that the Administration's focus on Public-Private Partnerships (PPPs) as tools to attract necessary infrastructure investment was overblown, arguing instead that straightforward concessions made more sense. He was cautious about how quickly these measures would have an effect, venturing that "Brazil won't hit sustained 6% growth right away." But, even sustaining 3.5% growth would be double the rate of the last decade, he continued, and sustained growth would, in turn, encourage investment.

¶16. (SBU) Having just returned from the Berlin finance G-20 meeting, Meirelles was not concerned in the short-run about the weakening dollar. There is no reason to panic, he said, although there clearly needed to be an adjustment of the U.S. current account numbers in the longer term. Finance Minister Palocci, by contrast, appeared concerned about the manner in which this adjustment took place. He stated that an adjustment must be made, and could be implemented either by the market or by monetary authorities. Palocci said he hoped the U.S. authorities would do so, in order to ensure it was a gradual process. It is the uncertainty about the manner of adjustment, less so than the adjustment itself, that could hurt open, emerging markets such as Brazil, Palocci opined.

¶17. (SBU) Palocci assured Shirzad that, while occasionally the subject of public controversy, there would be no backtracking on the GoB's orthodox macroeconomic policies. The task for the future, he stated, was to consolidate the microeconomic reforms, e.g., improving the business environment, strengthening credit markets and extending their reach, and improving the functioning of securities markets. The tax burden was high, Palocci admitted, noting the GOB was targetting tax reductions to stimulate long terms savings and reduce the tax burden on items that are staples for the poor. He added that tax reductions also would be accorded to small businesses through a bill, recently sent to Congress, that would reduce the number and rates of taxes on small businesses and simplify business registration in an effort to reduce informality in the economy.

¶18. (SBU) Turning to regional issues, Palocci admitted that he had some concerns about Argentina and Bolivia. If Argentina did not reach a reasonable agreement with its creditors and its current growth stalled, it could cause some pain in the region, he said. He did not foresee much direct effect from an Argentine crisis on the markets' pricing of Brazil risk, but worried about the liquidity effects as investors reconsidered their overall appetite for emerging

market risk. Bolivia, is "always tense," Palocci ventured, adding that the GOB has had an ongoing dialogue with both President Mesa and the opposition. In addition to urging moderation, he observed, Brazil hopes to develop useful relationships that would allow it to play a mediating role, if necessary.

Slightly Different View from Presidential Advisor Garcia
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¶19. (C) In addition, D/NSA Shirzad met with GOB Presidential Foreign Policy Advisor Marco Aurelio Garcia, a long-time Workers Party stalwart with close ties to Lula. Garcia spent much of the meeting discussing the economic chaos Lula inherited upon assuming office and the steps the president has taken to right the economy. Although Garcia cited much the same glowing economic numbers as Central Bank Chief Meirelles and FinMin Palocci, his presentation differed in several important respects.

-- While Meirelles merely referred to the possibility of the GOB declining to renew its Standby Agreement with the IMF, Garcia stated that a definitive decision had been taken to forego an IMF program when the current agreement expired in March 2005,

-- Unlike Meirelles - who thought that the maximum the Brazilian economy could expand without reigniting inflation was 3 to 3.5 percent - Garcia opined that sustainable growth of 4.5 to 4.7 percent was possible. (Garcia noted that between 1930 and 1980, the country grew at an average growth rate of 6.7 percent.)

-- In contrast to Meirelles and Palocci, who made clear that the GOB would maintain high interest rates as long as needed to staunch inflation, Garcia thought it essntial to lower interest rates as soon as possible to simulate investment. BNDES and the state-run commercial banks (Banco do Brasil, Caixa Economic Federal, and the GOB's Savings and Loan Bank) could shoulder the burden of financing much-needed public infrastructure investment, but lower rates overall were needed to generate a public/private investment boom.

-- Garcia stated that the GOB would likely soon begin replenishing its international foreign exchange reserves given that the real had appreciated against the falling dollar. With the lapse of the IMF Stand-by Program next year, he said, the GOB would have to do without immediate access to USD 25 million in potential IMF support -- though the GOB's estimated USD 9 billion current account surplus made the problem of foreign exchange supply much less acute.

-- Garcia also proved fairly sanguine regarding the ability of the GOB to straighten out in short order its social safety net programs, He thought that the Bolsa Familia program in which 4.5 million families participated in 2003, could be expanded to 6 families by the end of 2004 and 40 million by the end of 2006. Similarly, he foresaw expansion in the coming months of the GOB's agricultural credit programs for small farmers -- which help sustain the rural poor.

¶20. (C) In reponse to a question from D/NSA Shirzad about GOB plans regarding tax policy, Garcia noted that under the previous Cardoso Administration taxes as a percentage of GDP had increased from 28 percent to 38 percent during a span of 8 years. The Lula Administration, he said, planned to implement a series of targetted VAT tax cuts aimed at stimulating key sectors -- such as investment and basic consumer goods. Simultaneously, the GOB planned to simplify its VAT tax regime by imposing a uniform VAT tax rate across all its states (i.e., end the current "guerra fiscal," whereby states compete in offering ever-sweeter tax breaks for industry relocation). As for the income tax, Garcia declared, plans were in the works to make the system more progressive by increasing the number of tax brackets. (He did not specify whether the GOB would make this move revenue-neutral.)

¶21. (C) Comment. While Garcia's slightly different take on the sustainable growth rate of the economy and the need for lower interest rates reflects the traditional PT emphasis on national development, Palocci and Meirelles remain firmly in charge of macro-economic policy. Or as Meirelles put in at one point, "as long as Palocci and I are around we are going to make sure that economic policy is based upon concrete data, not wishful thinking. However, if you see us leaving the government, then I would start to worry."

Dinner with Sao Paulo Business Leaders

¶22. (SBU) Sao Paulo Consul General hosted a dinner for D/NSA Shirzad and Director Renigar on the evening of November 22. Dinner guests -- senior executives representing Brazilian and multinational companies in the banking, agro-industry, steel automobile, and packaging sectors -- noted that they believed

Brazil and other member countries would be better served by converting Mercosur in a free trade area (as opposed to its current form of a customs union). This, they observed, would leave individual membes free to negotiate other deals at their own pace, without having more protectionist members hold everyone else back. One participant observed tha Argentine industry is now merely a shell of what it once was, commenting that his factory operating there is making a lot of money because all his Argentine competition went broke. The same participant criticized the GOB's ill-prepared negotiating procedures, pointing out that the GOB went into the recently-failed Mercosur/EU trade talks without sufficiently consulting and defining positions/strategies, and subsequently had to regroup after it was too late. Regarding attempts to resolve bilateral Brazilian/Argentine trade disputes, this participant was equally critical of the GOB's lack of consultation and preparation. As a business member of the Brazilian team negotiating with Argentine counterparts, he stated that the Foreign Ministry gave the Brazilian private sector ten points on how to reach an agreement that were totally unrealistic, yet the MFA did not want to hear any disagreement. He caustically remarked that if he ran a business the same way the GOB ran trade negotiations, he would be broke within a week.

¶23. (U) This cable was cleared by D/NSA Shirzad prior to transmission.